Greenspan points to “significant uncertainties” in US economy

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In what could be his last semi-annual report to Congress on monetary policy, Federal Reserve Board chairman Alan Greenspan delivered his expected upbeat assessment of the state of the US economy. The baseline outlook, he said, is “one of sustained economic growth and contained inflation pressures”.

But Greenspan, who is due to retire next January unless legislation is introduced to further extend his term, did point to some “significant uncertainties that warrant careful scrutiny.”

Productivity growth appeared to have slowed from the peak that it reached in 2003 with the cause and duration of the slowdown “not yet clear.”

Energy prices were also a “major uncertainty” in the economic outlook, with a further major rise threatening to “cut materially” into private spending and thus slow the rate of economic expansion. Moreover, “prices for far-future delivery of oil and gas have risen even more markedly than spot prices over the past year” with market participants seeing “little prospect of appreciable relief from elevated energy prices for years to come.”

The third major “uncertainty” was the behaviour of long-term interest rates. In his report last February, Greenspan pointed to the fact that since the Fed had begun tightening short-term rates from the middle of last year, long-term rates on Treasury notes and corporate bonds had fallen, rather than increased as expected. This process has continued in the past six months.

The current yield on Treasury notes, he noted, was about 50 basis points below the level of late spring 2004, while “yields for both investment-grade and less-than-investment grade corporate bonds have declined even more than those of Treasury notes over the same period.” Such a pattern is “clearly without precedent in our recent experience.”

While not offering a solution to this “conundrum”, as he dubbed it last February, Greenspan did point to one of the most significant factors—the general decline in global investment demand.

At the macro level, he said recent figures suggested that the investment propensities of major economies had been declining in the recent period.

This “softness in intended investment” was also evident in corporate behaviour. In the United States, capital expenditures were below the “very substantial level of corporate cash flow of 2003”, the first time such a phenomenon had been seen since the severe recession of 1975. This development was most likely the result of “business caution” in the wake of the stock market decline and the “corporate scandals early this decade.”

But the decline in investment, reflecting the long-term decline in profitability in key areas of the global economy such as manufacturing, is only half the story. The policies of the Fed have been another significant factor. Ever since the stock market crash of October 1987, shortly after he took up his post as Fed chairman, Greenspan has sought to counter emerging problems by increasing the flow of money into the US and world economy. While this policy resolved problems in the short-term, it has exacerbated them in the longer term.

In the mid-1990s, for example, during the US stock market boom the Fed kept interest rates low in order to sustain the boom, fearing the consequences of a collapse.

Even though he had previously acknowledged the existence of a “bubble”, referring to “irrational exuberance” in late 1996, Greenspan became the market’s chief booster. He insisted that the historically unprecedented increase—the value of the stock market

was equivalent to 180 percent of gross domestic product in March 2000 compared to 33 percent at the start of the bull run in 1982—was due to productivity increases induced by computer technology.

When the bubble eventually burst, Greenspan's response was to cut the Fed's base interest rate to just 1 percent, the lowest level in 46 years, in order to stabilise the US economy.

But the effect of these measures has been to create a wave of money that moves around the world in search of opportunities for profit in the various financial markets. As one market collapses or the profit opportunities are exhausted, so the wave moves on. This has now led to the situation where the so-called risk premium—the difference in yields on virtually risk free investments such as Treasury notes and longer-term or riskier investments such as corporate bonds—has been compressed.

One of the most significant effects of this process can be seen in the housing market bubble in the US. With long-term interest rates in decline, mortgage rates have remained low, sparking an unprecedented rise in house prices. Average house prices across the US have increased by 50 percent in the past five years, with some regions showing a doubling in prices. This compares with an average real increase of 0.4 percent per year from 1890 to 2004.

Just as he had claimed that it was impossible to say that the stock market rise of the 1990s was a "bubble", Greenspan insisted that it was "difficult to ascertain" whether home prices were "overvalued relative to underlying determinants". However, he did acknowledge that low rates on Treasury notes and mortgages "have been a major factor in the recent surge of homebuilding, home turnover, and particularly in the steep climb of home prices."

This "apparent froth" in the housing market had interacted with developments in mortgage markets. There was an increase in interest-only loans and "more exotic forms of adjustable rate mortgages" which "some households" may be using to purchase homes that would otherwise be unaffordable. The danger was that these contracts could leave homebuyers vulnerable to "adverse events" and some buyers may not be able to meet interest payments should conditions change.

A collapse in the housing market would have immediate repercussions not only for homebuyers, many of whom are financially stretched, but for the US economy as a whole. In the past five years, consumer spending has been sustained to an increasing extent by funds derived from home-loan refinancing. In the aftermath of a downturn or recession, consumption spending is generally financed by an increase in the labour force and rising wages. That has not been the case in the wake of the 2000-2001 recession.

Figures on the US labour market continue to show that the expansion of the workforce is taking place at the slowest rate in the post-war period. Last June there were 1.6 percent more jobs than in June 2004. This was certainly up on the annual rate of just 0.5 percent from the end of the recession in November 2001 to June 2004. But compared to the same period in previous expansionary phases since World War II, the last 12 months had the lowest rate of job growth. For recoveries lasting longer than 43 months—the length of the present upturn—the average rate of job creation has been 3.4 per cent. In other words at 1.6 percent, the current expansion is less than half the previous average.

Greenspan told the Congress that notwithstanding the challenges, the US economy remained on a "firm footing". But despite his optimistic outlook, all the figures continue to point to underlying imbalances.